

The Authority's final decision and analysis on the application for certification as unbundled by Diamond Transmission Partners Walney Extension Limited

This document explains the Authority's final decision on compliance by Diamond Transmission Partners Walney Extension Limited (the **Applicant**) with the requirements of the Third Package¹ for transmission system operators (**TSOs**) to unbundle from generation, production and supply undertakings as implemented into the domestic legislation in Great Britain (**GB**).

1. Certification Decision

- 1.1. Having taken utmost account of the European Commission's (the **Commission**) opinion on our preliminary certification decision on the application for certification submitted by the Applicant, the Authority² concludes that the Applicant complies with the requirements of the ownership unbundling model as set out in GB legislation and should therefore be certified as ownership unbundled.

2. GB Legislation – Transposition of Directive 2009/72

- 2.1. In GB, the ownership unbundling requirements set out in the Electricity Directive have been transposed through the Electricity and Gas (Internal Markets) Regulations 2011 which inserted sections 10A to 10O into the Electricity Act 1989 (the **Electricity Act**). Section 10F of the Electricity Act – 'the ownership unbundling requirement' – states that "*the ownership unbundling requirement is met by an applicant for certification if in relation to each of the five tests ... – (a) the Authority thinks that it is passed, or (b) it is treated as passed by virtue of subsection (7), (9) or (9A)*". In accordance with subsection 10F(9A), where one or more of the tests is not passed, we may decide to treat such tests as passed if the Authority is satisfied that there is no risk of discrimination and it would be appropriate and in line with our principal objective and general duties to do so.³

¹ The term "Third Package" refers to Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (**Electricity Directive**); Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003 (**Electricity Regulation**); Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (**Gas Directive**); Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 (**Gas Regulation**); and Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators.

² The Gas and Electricity Markets Authority (the **Authority**). In this document, the terms "**Authority**", "**Ofgem**", and "**us**" are used interchangeably.

³ https://www.ofgem.gov.uk/system/files/docs/2017/08/certification_open_letter_2017.pdf

3. The Applicant

- 3.1. Diamond Transmission Partners Walney Extension Limited is expected to become the licensed offshore transmission owner (**OFTO**) for the Walney Extension offshore transmission system in early 2020.

4. Summary of Ofgem analysis

- 4.1. *First test: The applicant (a) does not control a relevant producer or supplier; (b) does not have a majority shareholding in a relevant producer or supplier; and (c) will not, on or after the relevant date, exercise shareholder rights in relation to a relevant producer or supplier.*
- 4.2. The Applicant has confirmed that it does not hold shares in, nor control, any other company. Furthermore, the Applicant has provided a signed undertaking that, during the term of its electricity transmission licence, it will not exercise, or cause to be exercised on its behalf, any shareholder rights in relation to a relevant producer or supplier that it might acquire during the currency of the undertaking. Therefore, the Applicant meets the requirements of the first test.
- 4.3. *Second Test: Where the applicant is a company, partnership or other business, none of its senior officers has been, or may be, appointed by a person who (a) controls an electricity undertaking which is a relevant producer or supplier; or (b) has a majority shareholding in an electricity undertaking which is a relevant producer or supplier.*
- 4.4. The Applicant has provided details of the process for appointing directors. It meets the requirements of the second test as none of its senior officers has been, or may be, appointed by a company or a person who: (a) controls an electricity undertaking which is a relevant producer or supplier; or (b) has a majority shareholding in an electricity undertaking which is a relevant producer or supplier.
- 4.5. *Third Test: Where the applicant is a company, partnership or other business, none of its senior officers is also a senior officer of an electricity undertaking, which is a relevant producer or supplier.*
- 4.6. The information provided by the Applicant confirms that none of its directors is also a senior officer of an electricity undertaking which is a relevant producer or supplier. The Applicant therefore meets the requirement of the third test.
- 4.7. *Fourth and Fifth Tests: The applicant is not controlled by a person who (a) controls a relevant producer or supplier; or (b) has a majority shareholding in a relevant producer or supplier.*
- 4.8. The Applicant is ultimately controlled by Mitsubishi Corporation (**MC**), HICL Infrastructure PLC (**HICL**), InfraRed Capital Partners (Management) LLP (**InfraRed**) and Chubu Electric Power Co., Inc (**Chubu**). The Applicant has provided a comprehensive account of the corporate structures of its controllers. We consider that HICL does not

have an interest in or control over any relevant producers or suppliers. MC, InfraRed and Chubu hold the following participations in the EEA which qualify as relevant producers or suppliers:

4.9. MC

- **Luchterduinen Offshore Wind Farm Project:** MC has a 50% share in this 129MW wind farm, located off the coast of The Netherlands.
- **Norther Offshore Wind Farm Project:** MC has a 12.5% share in this 379MW wind farm, located off the cost of Belgium.
- **BESS Project:** MC has a 50% equity interest in a 48MW battery energy storage system project which connects to the TenneT transmission system in Germany.
- **OVO Energy:** MC has a 20% minority interest in this electricity supply company, based in GB.

4.10. InfraRed

- **Crystal Rig II Limited:** InfraRed has a 49% share in this 138MW onshore wind farm located in the east of Scotland, GB.
- **Statera Energy Ltd:** InfraRed has a 70% share in this project, which is proposing to fund the roll-out of a pipeline of three 50MW flexible gas and one 50MW battery storage projects in UK.
- **Sheringham Shoal Offshore Wind Farm:** InfraRed has indirect control of this 316.8MW offshore wind farm located off the coast of GB.
- **Merkur Offshore Wind Farm:** InfraRed has a 25% interest, in this 396MW offshore wind farm located in Germany.
- **Pallas Windfarm Ltd:** InfraRed has a 100% interest in this 55MW onshore wind farm, located in the Republic of Ireland.
- **Pallas Energy Supply Limited:** InfraRed controls this electricity supplier operating under a "supplier-lite" arrangement in the Republic of Ireland.
- **Jadraas Vindkraft AB:** InfraRed has a 100% interest in this 212.9MW onshore wind farm, located in Sweden.
- **Erstrask Vind AB:** InfraRed has a 75% interest in this 229.1MW onshore wind farm, located in Sweden.

4.1.1. Chubu

- **Gunfleet Sands Limited and Gunfleet Sands II Limited:** Chubu has a 25% interest in this 172.8MW offshore wind farm located off the coast of GB.



4.1.2. Section 10F(9)(A) of the Electricity Act provides that the Authority can use its discretion to treat one or more of the five tests as passed in certain circumstances. Further information on the factors that we consider particularly relevant in assessing the risk of discrimination and our ability to exercise discretion are detailed in our August 2017 open letter (the **Open Letter**).⁴

4.1.3. While the Applicant's controllers do also control, and in some cases hold a majority shareholding in, relevant producers or suppliers, the Applicant has demonstrated to our satisfaction that it does not have a relationship with these relevant producers or suppliers that might lead the Applicant to discriminate in favour of those relevant producers or suppliers. The Authority considers it appropriate to treat the fourth and fifth tests as passed in accordance with section 10F(9A) of the Electricity Act. The Applicant therefore meets the requirements of the fourth and fifth tests.

5. European Commission Opinion

5.1. The Commission's opinion dated 5 December 2019 was received by Ofgem on 9 December 2019 (the **Opinion**).

5.2. In the Opinion, the Commission considers that certification of the Applicant would not "*align with the clear wording of the Directive*" and invites Ofgem to reconsider its assessment that, "*given the existing generation and supply interests, Walney Extension OFTO meets the requirements for being certified as ownership unbundled TSO.*"

5.3. The Opinion sets out the relevant unbundling legislation. Articles 9(1)(b)(i) and 9(1)(b)(ii) of the Electricity Directive prohibit the same person or persons from directly or indirectly exercising control over a TSO or over a transmission system, and directly or indirectly exercising control or exercising any right over an undertaking performing any of the functions of generation or supply.

5.4. The Commission recognises that, "*there may be exceptions to the strict application of EU unbundling rules*" and, as set out in the Staff Working Paper⁵, that "*a certification of a TSO should not be refused in cases where it can be clearly demonstrated that there is **no incentive and ability** for a shareholder in a TSO to influence the TSO's decision making*

⁴ <https://www.ofgem.gov.uk/publications-and-updates/certification-arrangements-great-britain-following-amendments-ownership-unbundling-requirements-gas-act-1986-and-electricity-act-1989-0>

⁵ The Staff Working Paper is [here](#).

in order to favour its generation, production and/or supply interest to the detriment of other network users."

5.5. The Commission further notes that:

*"[it] considers that the means with which the legislator intended to pursue the objective of removing any conflict of interest between, on the one hand, generators/producers and suppliers and, on the other hand, TSOs is to provide for a **structural** solution for the problems that owners of electricity or gas infrastructure may use the ownership over this infrastructure (constituting a natural monopoly or an "essential facility") to favour their own generation or supply business."*

"The unbundling regime pursuant to EU legislation is meant to prevent such practices and replaces the previous regime of behavioural measures [...] which excludes the possibility to use infrastructure to influence competition"

"Exceptions to the strict application of EU unbundling rules should therefore be limited to cases where, due to an unambiguous absence of an incentive and ability for a shareholder in a TSO to influence the TSO's decision-making in order to favour its generation and/or supply interest to the detriment of other network users, prohibiting persons(s) from investing in a TSO would be disproportionate."

5.6. The Commission agrees with Ofgem that generation and supply interests controlled by the Applicant's controllers located outside the EEA do not pose a risk as regards to a possible conflict of interest; due to the geographical distance, there is neither a direct link nor physical connection between the markets.

5.7. The Commission acknowledges that many generation interests of the Applicant's controllers located within the EEA are of a relatively small scale and are geographically distant from the transmission system to be operated by the Applicant. However, the Commission invites Ofgem to take the "*cumulation of smaller generation capacities*" into account when assessing whether there is an incentive and ability for a shareholder in a TSO to influence the TSO's decision-making in order to favour its generation or supply interest to the detriment of other network users.

5.8. The Commission considers that the Applicant's controllers hold "*substantial participations in generation and supply interests located in the UK or neighbouring countries*" and notes future "*plans for additional considerable investments in such assets*". The Commission considers that the Applicant's controllers' 3% share of the GB generation market (which may raise to 4% by the fourth quarter of 2021), constituted a substantial participation.

5.9. The Commission acknowledges that where generation activities have a guaranteed income and are not sensitive to wholesale price fluctuations, there is less scope for a conflict of interest. However, the Commission notes that, for example, a Contract for Difference (**CfD**) granted to renewable generators is usually limited to 15 years, after which the produced electricity would be traded on the market and that one of the

contracts held by one of the Applicant's controllers' generation interests with National Grid would end in 2025.

5.10. The Commission notes that both InfraRed and MC were shareholders in other OFTOs, and that it had previously asked Ofgem to investigate further, as to whether *"there is sufficient certainty that MC and InfraRed will not have any incentives to influence the markets using their transmission lines."*

5.11. The Commission also notes Ofgem's opinion that:

- *"only flexible generation can be used to exert market power"* and thus it is highly unlikely that the Applicant's controllers could exert market power.
- That although interconnection to the UK's neighbouring countries is limited, this is a transitory situation, and referred to the UK Government's plans to add a further 9.5GW of interconnection capacity.
- Ofgem's view that the ability to exert market power was limited. The Commission considered that the absence of market power was *"not sufficient to pass the legal test established by the Staff Working Paper as to whether a conflict of interest can be clearly excluded."* It is the Commission's view that *"the fact that an exercise of market power by the Applicant's controllers via their generation interests is merely 'highly unlikely' demonstrates that a conflict of interest cannot be excluded."*

5.12. The Commission also acknowledges that the OFTO regime, as well as the rules according to which NETSO⁶ manages the electricity system, provide for a range of regulatory behavioural safeguards. However, the Commission considers that there are limits to the extent such regulatory safeguards can be considered as suitable replacements for the structural separation set out in the Electricity Directive.

5.13. In determining whether or not there is a conflict of interest and if we can exercise our discretion, we have considered this application in line with our obligations under section 10F(9A) of the Electricity Act. Pursuant to Article 3(2) of the Electricity Regulation, we have taken utmost account of the Commission's Opinion outlined above. We have also considered the Staff Working Paper and our own guidance as set out in the Open Letter. The factors we have taken into consideration when assessing this application are summarised below.

Market share and ability to exert market power

5.14. One of the factors we look at when considering whether we should apply our discretion is whether an Applicant has a relationship with any relevant producers or suppliers that have a large market share. We would have particular concerns about the risk of

⁶ NETSO is the National Grid Electricity System Operator or NG ESO. Also known as the System Operator.

discrimination where there was a large market share, as a large market share increases the potential for any one generator to influence price.

- 5.15. We have considered whether the Applicant or its controllers have any opportunity to discriminate as a result of their share in the GB and EU electricity generation markets. We consider that the Applicant's controllers currently do not have sufficient interests in the GB or EU market to exert market power, for the reasons set out below.
- 5.16. The Applicant's controllers' share of the EU electricity market is below 0.01%, which we consider to be insufficient to enable them to exert any market power.
- 5.17. Our State of the Energy Market Report 2019⁷ notes that the wholesale electricity market in GB is moderately concentrated, with the eight largest electricity companies providing 72% of metered volumes in 2018.
- 5.18. In general, market power is more likely to be exerted in shorter timeframes (for example, individual days or hours). This is because the circumstances that often create periods of system stress are relatively transient (e.g. peaking demand, unplanned outages, variable wind output). In shorter timeframes, only flexible generation can be used to exert market power. The majority of generation controlled by the Applicant's controllers is wind generation, which is considered to be inflexible as it is dependent on the strength of the wind at any given time.
- 5.19. Therefore, in practice, the Applicant's controllers' aggregate share of the GB generation market of around 3% (taking all GB generation interests into account) falls to under 1% of the GB market share when only those generation interests that could benefit from any fluctuation in market prices are included in the calculation.
- 5.20. As such, we do not consider that any of the generators controlled by the controllers of the Applicant could have the ability to exert market power, nor do we consider that they would have any incentive to do so. Incentives for discrimination are discussed further at paragraphs 5.26 to 5.28 below.

Role in GB electricity market

- 5.21. The Applicant has a very limited role in the GB electricity market, namely as the owner and operator of the offshore transmission system, which transmits electricity from the Walney Extension offshore wind farm to the onshore transmission system. In theory, the Applicant could limit the connected wind farm's ability to export the electricity they have generated. When operating at 100% capacity, this would be 660MW (or 0.6% of total generation capacity in GB).⁸

⁷ <https://www.ofgem.gov.uk/publications-and-updates/state-energy-market-2019>

⁸ This is the capacity of Walney Extension Offshore Wind Farm – the wind farm connected to the Walney Extension offshore transmission system. Source: TEC Register <https://www.nationalgrideso.com/connections/registers-reports-and-guidance>

- 5.22. We have investigated whether the Applicant's controllers' have any incentive to influence the market using their transmission systems. The Applicant's controllers including MC and InfraRed have shares in the transmission systems connecting other offshore wind farms to the onshore transmission system. Again, in theory, the Applicant's controllers could limit the connected wind farms' ability to export the electricity they have generated. This could, if each wind farm were to operate at 100% capacity, impact a maximum total generation capacity of approximately 1.8GW on the GB electricity wholesale market (noting that offshore wind farms are likely to operate at an approximate load factor of 38.6% to 47.3% of their maximum capacity).
- 5.23. Total demand margins (additional generating capacity available to the GB transmission system over and above expected requirements) for winter 2019/20 are approximately 7.5 to 9.0GW. Given the demand margins are significantly greater than the total generating capacity transmitted by the transmission systems of the Applicant's controllers, we do not consider that the removal of up to 1.8GW of generation in this case would result in the ability of the Applicant's controllers to influence market prices by deliberately creating shortages in available generation. In any case, the risks of penalty for such behaviour (outlined in paragraphs 5.26 to 5.28) outweigh the benefits.

Future developments

- 5.24. We note the GB Government's plans for future interconnector connections, which intend to add a further 9.5 GW of interconnection capacity to the current 3 GW capacity within a decade. We also note that the Applicant's controllers have a generation interest that has a Short Term Operating reserve (**STOR**) contract⁹ due to end in 2025, after which the energy generated will be traded on the wholesale market. We will assess future interconnector connections and changes to generation interests as part of our continued monitoring as set out in sections 10I, 10J and 10L of the Electricity Act.
- 5.25. The Applicant's controllers also have interests in future generation projects will affect the Applicant's controllers' market share once operational. We have been informed by the Applicant that these investments will not be in place at the time at which the Applicant is expected to be certified and the transactions details are not yet sufficiently certain for the Authority to undertake properly informed consideration. As such, these future investments are excluded from our assessment.

Risks and penalties as a result of anti-competitive behaviour

- 5.26. Even if the Applicant's controllers were to attempt to discriminate in favour of their own generation interests to the detriment of other networks users, there would be a number of risks in doing so, including:

⁹ The NETSO can procure sources of extra power ahead of time through the STOR service, and generators can contract to provide that power.

- due to the extent of the Applicant's controllers' market share there would be no certainty that their actions would in fact result in a shortage on the GB transmission system; and
- as the NETSO manages flows on the GB transmission system so that supply matches demand, the Applicant's controllers' would not know whether it would be their generation interests that would be despatched in the unlikely event that their actions did create a shortage on the GB transmission system.

In addition:

- the Applicant's OFTO licence will include a number of obligations that further limit the possibility that the Applicant or its controllers could discriminate in favour of any relevant producers or suppliers. For example, an OFTO could be penalised up to 50% of its revenue stream (10% per year, over a period of five years) where its transmission system availability falls below 98%. A 10% deduction in annual revenue would impact on what are already tight project internal rates of return (IRR). These IRRs are deliberately extremely slender in order to win the competitive bidding processes to become an OFTO, run by Ofgem. Any action that would deliberately reduce this would have material impacts on the value of the investment. Further, it may breach various lending covenants agreed with an OFTOs lenders. On average, a 10% penalty is estimated at between £30m and £34m, depending on the revenue of the project.
- Ofgem scrutinises market behaviour to distinguish price spikes that reflect actual market conditions from those that could mean market abuse. Where there is evidence of this, Ofgem can take action under: the Competition Act (which provides for the possibility of a financial penalty of up to 10% of a company's annual turnover, where anti-competitive behaviour has occurred); the Transmission Constraint Licence Condition (where generators can be penalised up to 10% of their annual turnover, where market or price manipulation has occurred); and the EU regulation on energy market integrity and transparency (**REMIT**).
- Ofgem acts quickly to launch investigations where the loss of generation capacity has a significant effect on energy prices or supplies to consumers, and would take action to penalise any anti-competitive or manipulative behaviour identified by such an investigation.

5.27. Ofgem considers, therefore, that the possibility of circumstances occurring where foregoing transmission income may be profitable in view of extra earnings by generators is near absent, and that the above outlined penalties and risks are deterrent enough to avoid any abuse of the system by the Applicant and/or its controllers'.

5.28. We agree with the Commission that *"there are limits to the extent such regulatory safeguards can be considered as suitable replacements for the [...] structural separation imposed by the Union legislator."* However, we consider that the regulatory safeguards

are deterrent enough to avoid any abuse of the system by the Applicant and/or its controllers’.

Conclusion

- 5.29. We have considered the Commission’s opinion alongside the Staff Working Paper, the Electricity Directive, the Electricity Act, and our Open Letter. We have noted, in particular, the Commission’s concerns relating to the requirement for structural separation in unbundling and the approach to exceptions to the strict unbundling rules set out in the Staff Working Paper and as enacted in our discretionary powers under the Electricity Act.
- 5.30. The Staff Working Paper is clear that all cases must be examined with an in-depth analysis, on a case-by-case basis, and sets out factors that may be considered including geographical location, the size and market share of the generation, and production and/or supply interests. These factors are aligned with the guidance on our discretionary powers set out in the Open Letter, which also requires us to consider the Authority’s principal objective and general duties.
- 5.31. The objective of the unbundling rules is to remove any conflict of interest between generators/suppliers and transmission system operators. The Commission note in the Staff Working Paper that this objective would not be achieved if *“certification of a TSO were to be refused in cases where it can be clearly demonstrated that there is no incentive for a shareholder in a TSO to influence the TSO’s decision-making in order to favour his generation, production and/or supply interest to the detriment of other network users.”*
- 5.32. Having considered the Staff Working Paper, the Commission’s Opinion, our Open Letter and the relevant legislation, we consider that, whilst the Applicant’s controllers do hold generating assets in the GB market, an incentive for the controllers to influence the decision making in the Applicant to favour its generation interests or to discriminate against actual or potential competitors could not be identified.
- 5.33. We are satisfied that none of the Applicant’s controllers (either separately or in combination) has sufficient market share to exert market power. We conclude that the risk of discrimination is negligible as a result of GB market share. Neither the Applicant nor its controllers’ have any incentive to discriminate.
- 5.34. The Commission invited Ofgem to continue monitoring this case to ensure that no new facts emerge which would justify a change in its assessment. In compliance with the GB legal framework and the Electricity Directive, we will continue to monitor whether the basis upon which the Authority decided to certify the Applicant continues to apply. This includes in respect of any future generation, production and/or supply interests that may be acquired, and at the start of operations of any further generation, production and/or supply interests. Further, a condition of the final certification decision requires the

Applicant to regularly notify us of any relevant changes in circumstances that may affect its eligibility for certification.

6. Controller from a third country

- 6.1. Mitsubishi Corporation and Chubu are incorporated and registered in Japan. As Japan is a third country for the purposes of this certification assessment and section 100 of the Electricity Act, we notified our Government on 24 June 2019 in accordance with section 10B(3) of the Electricity Act. On 1 August 2019, the Government concluded that certifying the Applicant would not put the security of electricity supplies in the UK or any other EEA states at risk. The Commission also concluded the same in its Opinion.

